

## Economic Questions Raised in Iraq's New Constitution

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### Introduction

The 1990s and early 21st century have witnessed increased interest in federalism as a viable system for conflict-prone societies, especially those in the developing world. Federalism has been promoted as an optimal arrangement for responding to ethnic diversity. Its main strengths lie in the fact that it grants internal self-determination to territorially concentrated groups; makes for institutional expression of pluralism; and enhances political participation, equality, accountability, and efficient and equitable provision of services.

Iraq is the latest country to consider adopting a federal system of government. Yet despite the potential advantages of a federal system the debates in Iraq have become increasingly polarized. Sunni Arab delegates on the constitutional commission have accused the dominant Shia and Kurdish factions of seeking to force the constitution through despite the lack of a consensus over some of its most sensitive elements.

With the ratifying of the Constitution on October 15, 2005, many observers<sup>[1]</sup> contend that that unless the more contentious issues are resolved quickly, the integrity of Iraq as a unified state will be in question. Several of these issues center on the economic aspects of federalism. The sections below will examine the two most critical in this regard:

- the orientation of the economic system to be adopted (efficiency vs. security/welfare), and
- the treatment of the country's petroleum resources. What are the possible consequences for each implied by the new Constitution? The implications for federalism?

### Main Economic Issues Addressed

Developed largely by the Shia and Kurdish blocs, the Constitution adopts an extremely strong form of federalism. The result is a constitution that makes it both easy and attractive to form other

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multi-province regional governments. Each of these regional administrations can choose to wield greater legal and executive powers than the federal government.

## **The Constitution: General Economic Provisions**

The detailed economic sections begin with Article 22. Many of the economic articles can be found in most modern-day constitutions. Several have direct bearing on the issue at hand:[2]

### **Article 22:**

- 1st: Work is a right for all Iraqis in a way that guarantees them a good life.
- 2nd: The law regulates the relation between employees and employers on an economic basis, while keeping in consideration rules of social justice.
- 3rd: The state guarantees the right to form or join syndicates or professional unions. This shall be regulated by law.

### **Article 23:**

- 1st: Private property is protected and the owner has the right to use it exploit it and benefit from it within the boundaries of the law.
- 2nd: Property may not be taken away except for the public interest in exchange for fair compensation. This shall be regulated by law.
- 3rd: (a) An Iraqi has the right to ownership anywhere in Iraq and no one else has the right to own real estate except what is exempted by law. (b) Ownership with the purpose of demographic changes is forbidden.

### **Article 24:**

- The State shall guarantee the freedom of movement for workers, goods and Iraqi capital between the regions and the provinces. This shall be regulated by law.

### **Article 25:**

- The state shall guarantee the reforming of the Iraqi economy according to modern economic bases, in a way that ensures complement investment of its resources, diversifying its sources and encouraging and developing the private sector.

### **Article 26:**

- The country shall guarantee the encouragement of investments in the different sectors. This shall be regulated by law.

### **Article 27:**

- 1st: Public property is sacrosanct, and its protection is the duty of every citizen.
- 2nd: Regulations pertaining to preserving and administering state property, the conditions set for using it and the cases when giving up any of the property may be allowed shall be regulated by law.

### **Article 28:**

- 1st: Taxes and fees shall not be imposed amended, collected or eliminated except by law.
- 2nd: Low income people should be exempted from taxes in a way that guarantees maintaining the minimum level necessary for a living. This shall be regulated by law.

## Implications of the General Economic Provisions

Before examining the implication of the Constitution's main economic provisions, a word of caution is in order.<sup>[3]</sup> The impact of a constitution on economic policy in particular and on economic performance in general is not simply a matter of the text itself. For one thing, constitutions can be written or unwritten. Some countries with a written constitution also have unwritten constitutional conventions. In the United States, for instance, the independence of the central bank (The Federal Reserve Board) is not explicitly stated in the constitution as it is in some others. Yet the board enjoys considerable de facto autonomy because an unwritten convention ensures that the executive and the legislature would incur costly political sanctions if they tried to interfere.

Second, constitutions can be effective or ineffective. The constitutions of the formerly communist countries played no role in regulating political life. In many countries today, the constitution is little more than a piece of paper.

Third in countries with a constitutional tradition, the real constitution consists of the thousands of court decisions that have spelled out the abstract and general provisions of the original document and adjusted them to changing circumstances and problems that were unforeseen and unforeseeable at the time the constitutions were formulated.

With these caveats in mind, if implemented, the Articles noted above would establish a modern, market driven economy.<sup>[4]</sup> In many ways the Constitution will result in a continuation of the controversial neoliberal economic reforms<sup>[5]</sup> introduced in late 2003. At that time, the Coalition Provisional Authority (CPA) enacted laws that: (a) give foreign investors equal rights with Iraqis in the domestic market; (b) permitted the full repatriation of profits; (c) instituted a flat tax system; (d) abolished tariffs; (e) enforced a strict intellectual property rights regime; (f) planned to sell off a whole range of state-owned companies; (g) prepared to reduce food and fuel subsidies; and (h) eventually privatize many social services such as health, education and water delivery.<sup>[6]</sup>

Whether the Constitution's economic agenda is the best way to proceed at this time is certainly an open question. Debates in modern political philosophy are to a large extent organized around two polar positions. On the one hand there is the view that societies ought to maximize some aggregate utility or wealth in the sense of dynamic growth over time rather than static allocative efficiency. On the other hand, there is the view (usually associated with John Rawls) that societies ought to assure the highest level of well being for the worst-off members. The first view is often referred to as the efficiently-oriented and to the second as the security oriented.<sup>[7]</sup>

The economic sections of the Constitution agreed upon toward the end of August 2005 set a somewhat different tone than in earlier versions. As late as June 30, 2005 drafts of the constitution made repeated calls for "social justice" as the basis of building society. This emphasis was missing in later versions.

The Iraqis wanted, at least on paper, to build a Scandinavian-type welfare system in the Arabian desert with Iraq's vast oil wealth to be spend on upholding every Iraqi's right to education, health care, housing and other social services. "Social justice is the basis of building society," the draft declared. All of Iraq's natural resources would be owned collectively by the Iraqi people. Everyone would have the right to work and the state would be the Iraqi people's collective instrument for achieving development.<sup>[8]</sup>

In short the writers of the Constitution appear to have shifted from a security oriented constitution to one more focused on attempting to achieve high levels of economic efficiency. It is not clear why the shift in emphasis occurred. One analyst feels[9] it was a result of U.S. pressure. This interpretation is consistent with the observation of a Sunni negotiator who concluded: "This constitution was cooked up in an American kitchen, not an Iraqi one." [10]

This shift in emphasis of the market over the state has a number of implications, especially if the country's poor economic performance continues. The rough picture we have at the present time is one of an economy that probably contracted by about 35% in 2003, recovering somewhat in 2004. At least 30% [11] of the labor force is unemployed with 60% depend on food rations to survive. A November 2004 survey [12] of 28,500 Iraqi families conducted by the government's Central Statistical Office (CSO) found the average monthly income of an Iraqi family was US\$127. Of those surveyed, only 15% had not completed elementary school, but just 9% had graduated from high school. Twenty percent of the respondents were illiterate.

While we still don't have a clear picture of the contemporary dynamics of the Iraqi economy, it's still safe to say that the country's economic health will be a key determinant of the of its long run stability. [13] Clearly factors such as the lack of commercial credit [14] together with uncertainty due to the security situation have largely brought investment in the formal segments of the economy to a halt. [15] Yet, from antidotal accounts [16] there are indications that many areas of the shadow economy are prospering and, as during the period of sanctions, successfully adapting to the harsh environment.

In short, the Iraqi economy currently exists as a huge welfare state. The government is the country's leading employer, paying the wages of around half the country's workforce. Yet for budgetary reasons there are plans to reduce the number on the state's payroll. The neoliberal reforms will only place further pressure on the government scale back many of its job creating activities. As things stand, many government ministries can carry out their duties with only about 40-60 percent of employees. [17] Yet with little private sector investment, it is hard to see how the unemployment rate can be reduced significantly.

The logical area of job creation, the American led reconstruction effort, has have had only a minor effect on employment with at most around 150,000 Iraqis are employed on such projects. The MLSA has established a network of training and recruitment centers in Iraq's major cities, but relatively few jobs have been found.

In May of 2005 the MLSA had found work for 115,000 Iraqis in the previous six months. Unfortunately in that time 110,000 people had applied for jobs in the MLSA centers in Baghdad, alone and more than 600,000 had registered across the country.

Given its current financial situation, the Iraqi government cannot afford to employ more people. Certainly over time the country's unemployment problems will have to be solved by the private sector. Unfortunately at this time most private companies outside the construction sector are not in a position to significantly increase their hiring. In fact, many Iraqi companies are struggling just to compete after years of protectionism and severe shortages of key inputs such as capital and technology. The surge of imports under the government's free trade policies while helping to keep inflation rates down has placed a severe strain on existing companies while discouraging investment on the part of new firms.

Instead of direct government action to create jobs, the Constitution implicitly assumes that this will occur through privatization. In May 2005, Iraq's Ministry of Industry announced plans to privatize most of its 46 state owned companies. The rationale underlying this decision was concern over the companies drain on the government's financial resources, in an attempt to reduce the financial burden on the state caused by the firm's large operating losses. Another rationale was that

privatization will help attract both domestic and foreign investment thus expanding the demand for workers.

Both assumptions appear unrealistic given the security situation and the intense competition faced by most firms. In fact there is considerable evidence that capital is flowing out of the country rather than into new productive activities. It has been estimated that by 2005 as much as US\$2billion of capital had left Iraq following the overthrow of Saddam Hussein. Jordan has attracted a large share of these funds. Perhaps even direr for the country's long-run economic viability is the massive brain drain of young Iraqis from the country. Again Jordan is a prime destination for many of the country's most talented youth and successful businessmen.[\[18\]](#)

To sum up, Iraq's new Constitution lays the beginnings of a foundation for moving ahead with the shock therapy economic program initiated by the Coalition Provisional Authority in 2003. Shock therapy is an apt term often used to describe the package of measures that transformed the economies of the former Communist countries of Central and Eastern Europe from communist to capitalist. These measures were highly controversial, with many economists, especially the "new institutionalists" contending that a more gradual approach could guide the transition to a market economy while avoiding much of the dislocation associated with shock therapy's the market driven, limited government approach.

To the new institutionalists, the experience of transition shows that the neoliberal policies of liberalization, stabilization and privatization that are not grounded in adequate institutions may not deliver successful outcomes. Yet the Constitution is silent on how and when the institutions needed to support the free market agenda are to be created.

The economic theories of federalism may provide some insights as to the manner in which this institutional development might proceed now that the Constitution has been ratified. First, Hayek[\[19\]](#) suggested that, because local governments and consumers have better information than the national government about local conditions and preferences, they will make better decisions. Second, Tiebout[\[20\]](#) argued that competition among jurisdictions allows citizens to sort themselves and match their preferences with a particular menu of public goods. In this spirit, Musgrave[\[21\]](#) demonstrated how the appropriate assignment of jurisdictions over public goods and taxes can increase welfare. Finally, Qian and Weingast[\[22\]](#) show that political institutions serve a similar role for government officials as firm institutions do for firm managers. Appropriately designed institutions help align the interests of public officials with citizens; in the spirit federalism can help government officials to maintain the positive and negative incentives necessary for thriving markets.

These theories of federalism, however, implicitly assume a fairly common set of economic systems across the various regions. For example, slightly different variants of free market capitalism across the various U.S. states with some states having more state financed programs than others. In the Iraqi case one can visualize a more diverse set of economic systems evolving in the three main regions. Elements of an Islamic economic system appeal to many Shiites and are one distinct possibility. The Many Sunni, frustrated over the country's dire economic plight and the seeming inability of the government to restore a sound economy often allude to the economic successes of the 1970s under socialism and state planning.[\[23\]](#) The Kurds have prospered in a relatively free market so the Constitution no doubt has wide appeal in that region. The Kurdistan Regional Government (KRG) is pro-Western, technocratic and investment friendly and Kurdish leaders want to exploit these features to attract western investment to the northern hydrocarbon sector.[\[24\]](#)

If a loose federation is agreed upon, it's easy to see the three major regions of Iraq adopting variants of these three somewhat different and potentially competing economic systems. Whether or not these systems will be able to coexist successfully is something the theoretical literature has yet to shed much light. Would the likely more efficient Kurdish system prevail over the less

productive? Given the availability of oil revenues and their possible allocations to the various regions, one can vision a number of outcomes where subsidies might enable the medium-term perpetuation of outcomes not commonly found in the developing world. As the theory of federations suggests, the potential might be there for an over-all efficient economy. As in many countries however, the “oil curse” may produce an outcome far from ideal.[25]

## Treatment of Oil in the Constitution

While important from the perspective of the country’s economic recovery and eventual growth and development, the debates over type of economic system to be adopted by Iraq have been rather low-key. Perhaps of all the articles in the Constitution those relating to oil have been the most contentious. The key provisions are outlined in Articles 109 and 110.[26]

### Article 109:

- Oil and gas is the property of all the Iraqi people in all the regions and provinces.

### Article 110:

- 1st: The federal government will administer oil and gas extracted from current fields in cooperation with the governments of the producing regions and provinces on condition that the revenues will be distributed fairly in a manner compatible with the demographical distribution all over the country. A quota should be defined for a specified time for affected regions that were deprived in an unfair way by the former regime or later on, in a way to ensure balanced development in different parts of the country. This should be regulated by law.
- 2nd: The federal government and the governments of the producing regions and provinces together will draw up the necessary strategic policies to develop oil and gas wealth to bring the greatest benefit for the Iraqi people, relying on the most modern techniques, market principles and encouraging investment.

Article 110 clarifies that revenue-sharing will be based on needs as well as demography, reflecting the region’s “duties and obligations, and taking into consideration the [region’s] resources and needs.

The wording of Article 110 hints that exploration and development strategy will be undertaken in partnership with the regions. The wording of Article 109 does not exclude foreign ownership of upstream oil industry assets, though most senior oil officials are not in favor of this level of foreign investment. Presumably, the detail of hydrocarbon development policy will be left to national and regional legislatures.[27]

The Constitution’s treatment of oil production and revenues present a number of unattractive scenarios to the Sunnis and it is easy to see why they have been quite opposed to the new charter. Specifically they are concerned with the creation of a federal system where they are at a major financial disadvantage vis-à-vis the Kurds and Shiites. In this regard, the Constitution defines a “region” as one or more provinces that choose by referendum to form a region. (A referendum can be called fairly easily: either by one third of the members in the relevant provincial councils or by one-tenth of the voters in these provinces. Moreover, two or more regions have the right to create a single larger region. “Here the Sunni nightmare in plain black and white: The Kurds are allowed to form a single supra-region in the oil-rich north, the Shiites to form theirs in the oil-rich south, while the Sunnis are left in the oil-dry center.”[28] Clearly the Sunnis fear that the Kurds and Shiites will create their own super-regions which will dominate Iraqi politics and economics.



As noted above, Article 110 addresses the resulting inequities by declaring that revenue from oil and gas extraction will be fairly distributed through the country according to need. However this section, Article 110, refers only to revenue from “current” oil and gas fields not from the vast untapped wells. Sunnis fear they will see little revenue derived from new wells brought on line in the future. As the Constitution stands the regional states are delegated authority over all new fields and therefore control over the negotiation of exploration contracts and the bulk of revenues derived from future production.

Article 110 suggests that the Sunni areas could be disadvantaged for some time on the ground that the Shia south and Kurdish north suffered chronic underdevelopment during the Saddam era. The exact formula for revenue-sharing will be fluid and shaped by Iraq’s national parliament where the Sunnis are likely to be a distinct minority.

The Kurdish government concluded at least three production- sharing agreements with Turkish and Norwegian companies in the last few years that cover several fields in the Kurdish areas. Those deals were done independent of the Iraqi oil ministry. At the same time, Baghdad did not recognize those agreements and warned companies against signing such agreements. With the new Constitution, such agreements would now become legal.[\[29\]](#)

While turning a de facto situation in Kurdistan into a legitimate state, the implications for the rest of Iraq are more significant. Iraqi oil experts warn that while the role of the federal government in oil matters has been marginalized, the powers of the Shiite oil producing region in the south are more likely to grow. At the moment there are two producing governorates in the south, Basrah and Missan. However, other governorates have non-exploited oil fields such as Nasiriyah, which contains the Gharraf oil field. According to the Constitution those governorates can set up regions and become semiautonomous like the region of Kurdistan.[\[30\]](#)

Related concerns have been expressed by a number of knowledgeable oil executives and industry analysts. The main concern is that the Constitution as worded could lead to several autonomous zones under which a central government in Baghdad would not have complete control over oil resources:[\[31\]](#)

*"Unless there is some central control, like a national oil company, there is going to be chaos, especially if preference is given to regional laws that would override federal laws."*—Muhammad-Al Zainy, senior energy economic analyst, Center for Global Energy Studies, London.

*"I am against federalism, it will not be good for the oil sector. It will only put it back instead of developing it."*—Shamkhi Faraj, director general of Economics and Oil Marketing.

*"The governorates are hardly able to take care of their local affairs let alone run an industry and negotiate contracts. I am certain that oil companies have been taken aback by this."*—Saadallah Al-Fathi, former senior Iraqi oil official.

*"The constitution does not have a clear, detailed or mature vision about the issue of oil. This is a recipe for chaos. We will not only lose central decision making in the process but also the question of legislation. Companies will face huge legal problems. If they sign with a political entity, their contract may not be protected in the long term."*—Mustfa Alani, Gulf Research Council.

Optimists say in the longer term, the decentralized government could lead to a faster development of Iraq’s oil and gas fields. However Sunni dissatisfaction with the Constitution could agitate the insurgency further and keep foreign investments at bay. In that case, only the Kurdish region, which has been spared the security problems characteristic of the rest of Iraq would be able to attract foreign companies to invest in developing its oil and gas fields.[\[32\]](#)



A good case can be made that the Constitution's treatment of the ownership and distribution of oil resources and revenues has the potential to contribute to the country's economic instability. Clearly, the Iraqi case has a number of unique aspects. However, before passing final judgment of the Constitution's treatment of oil, the experience of other oil producing federal countries may shed further insights as to the viability of the Iraq model.

## Lessons from Other Countries

Of the major oil producing countries the Nigerian experience<sup>[33]</sup> might provide the best insights for Iraqi oil policy at this point in time. Nigeria is a federal state. As with Iraq, oil is the main source of revenue—82 percent of the total revenue of the general government, or 40 percent of GDP in 2000.

## Revenue Transfer Mechanisms in Nigeria

In theory, the mechanism of revenue transfer is straight forward and a formal process set up to distribute funds. After so called first charges<sup>[34]</sup> are withheld, oil revenue is shared between the federal government and the state/local governments according to an arrangement whereby the remainder (over 75 percent of gross oil revenue) is divided between the central government and sub national governments. More specifically, the 1999 constitution assigns the control and collection of oil revenue to the federal government but attributes at least 13 percent of the net oil revenue to the oil producing states. In addition, about half of the net proceeds (after deduction of first charges) are redistributed to state and local governments according to a formula decided by parliament every five years. Excess proceeds over the budgeted revenue are also redistributed in the same way after assigning 13 percent to oil producing states.<sup>[35]</sup>

Nigerian states and local governments are highly dependent on revenue-sharing arrangements with the federal government. In 1999, 75 percent of state revenue came from redistributed revenue from the federal government, including their share of the VAT (85 percent of total proceeds), and 94 percent for local government revenue. Most of this revenue was oil related. Federation revenue released to sub-national governments rose from 7.4 percent of GDP in 1999 to about 15.3 percent of GDP in 2001.

The two key challenges posed by the Nigerian model of fiscal federalism are the conflicting claims over oil resources and the lack of fiscal discipline of sub-national governments. As sharing arrangements for oil revenue combine the derivation and the distribution principles they remain highly contentious. Given large disparities in natural resource endowments, oil is concentrated in only a few of the 36 states, which have onshore or offshore oil production.

Several of the main oil-producing states have called for total regional control over oil revenues. Other oil states have claimed that the 13 percent share accruing to oil producing states should also be applied to oil revenue from offshore production (which represents about 40 percent of oil revenue). Not happy with the manner in which their claims have been considered, the oil producing states have in effect simply refused to turn over the stipulated share of oil revenues to the central government.<sup>[36]</sup>

## Lessons for Iraq

Even Nigeria's relatively sophisticated revenue sharing agreement has led to severe political problems with the oil-producing states demanding and often just taking an increasing share of oil revenues. There is no reason to believe the allocation mechanisms system evolving out of the Constitution would fair any better.<sup>[37]</sup> In fact a strong case can be made that given the country's

ethnic make-up and geographic distribution of oil reserves, a future Iraqi federation would experience many of the problems currently plaguing Nigeria.

In Nigeria's case there is legal mechanism to impose fiscal discipline on the lower tiers of government. The high oil prices in recent years have led to a large increase in the distribution of financial resources to sub-national governments, particularly to oil producing states, without the corresponding assignment of new expenditure responsibilities. The resulting increase in aggregate demand has led to a rapid increasing in aggregate demand, and money supply, leading to inflation and a sharp depreciation of the currency in the parallel market.

The revenue sharing arrangement leaves virtually no room for maneuver on the fiscal side. It places the burden of macroeconomic adjustment on the federal government with control over less than half of the federation revenue.

Ideally financial resources to state and local governments should be insulated from oil price fluctuations, and commensurate with the tasks that they are assigned to perform and their capacity to effectively spend such resources. This would imply a shift from a transfer system which relies on the sharing of volatile natural resource revenues to one that provides for stable financing of the provision of at least a minimum set of essential sub-national public services.

Unless these safeguards are somehow incorporated into law or through a modification of the Constitution, one can easily visualize the proposed oil sharing arrangements in Iraq leading to increased macroeconomic instability, regional tensions and resentment, and over-all poor economic performance.

## Assessment

On a theoretical level, federalism is predicated on meeting two, seemingly irreconcilable goals: it seeks to unify diverse, often hostile localities under a single national banner, while allowing considerable authority to remain at the local level. When practiced well a federal system successfully reconciles the two demands, proving citizens with the simultaneous benefits of the protection of local specific rights, and the wider advantages of economies of scale and security allowed for by a larger national body.[38]

However, many of the case studies of federalist countries, especially in the developing world, stress the system's limitations: it threatens macroeconomic stability, institutionalizes discriminatory treatment of citizens, competition among groups and encourages them to ask for more powers which often lead to separation. In fact, the system has not performed well in the developing world. In Asia, Indonesia and Pakistan went federal at various times after independence, but quickly deserted it, while the Malaysian federation led to the exit of Singapore in 1965. In Africa, Kenya and Uganda adopted the system after independence but soon abandoned it too. In the case of Uganda it directly resulted in the political instability of the late 1960s and the civil war that ensued in the next decade.

The sections above have identified a similar set of potential problems that might arise now that the Constitution has been approved. Hopefully the next government with larger Sunni participation will see a more evenly balanced debate concerning the economic challenges facing the country.

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36. Adam M. Smith, "Fractured Federalism: Nigeria's Lessons for Today's Nation Builders in Iraq," *The Round Table* 94:1 (January 2005), 135.

37. *Ibid.*, 129-144.

38. *Ibid.*

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